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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

COMMENTS OF THE
CALIFORNIA CABLE TELEVISION ASSOCIATION

The California Cable Television Association ("CCTA") hereby files its comments on the Commission's Notice of Proposed Rulemaking ("NPRM")[1/] in the above-referenced docket regarding the price cap performance review for local exchange carriers of telecommunications services ("LECs"). In the NPRM, the Commission seeks comment as to "whether the [LEC price cap] plan should be revised to better serve the goals of the Communications Act and the public interest in the years ahead."[2/]

The LECs have fared extremely well under price-cap regulation even during the immediate past recessionary period. As the Commission reviews the performance of the LEC price cap plan, it must take special care to guarantee that monopoly telephone ratepayers will receive their fair share of the benefits of efficiency gains. Proper pricing of monopoly services will provide the additional benefit of preventing cross-

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1/ In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, FCC 94-10 (rel. Feb. 16, 1994).

2/ NPRM at ¶4.

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subsidization of LEC competitive entry into new services such as video dialtone.

The FCC can best foster its twin public interest goals of protection of consumers of LEC monopoly telephone services and prevention of anticompetitive pricing by the LECs through appropriate treatment of excess LEC profits by maintaining the sharing mechanism and continuing to not adjust the price cap index for depreciation rate changes. Specifically, CCTA urges the Commission to make the following policy choices:

- **Retain the sharing mechanism** to ensure that telephone ratepayers fairly participate in any efficiency gains engendered by the move from traditional rate of return regulation to price cap regulation;
- **Adopt rate reduction** to reflect the dramatic decrease in LECs' capital costs due to the steep decline in interest rates that generated windfall profits for the LECs during the first three years under price cap regulation;
- **Retain the prohibition on adjustments to the price cap index for depreciation rate changes** to ensure that the LECs cannot finance competitive entry into services such as video dialtone through increases in the price-cap ceilings due to accelerated depreciation for monopoly network components. These costs are not outside the LECs' control and should not be given "exogenous" or "Z-factor" treatment.

Each of these recommendations aims squarely at preventing the LECs from obtaining excess earnings from monopoly telephone services that can be used to subsidize below-cost pricing for competitive services. Only by adopting these policies will the Commission be able to adhere to the mandate of "fairness" in the "competition to build the information highway" that FCC Chairman Reed Hundt recently announced would be a guiding principle of the Commission in its policy decisions.[3/] To do otherwise --- to allow the LECs to eliminate the sharing mechanism, to keep their windfall profits, or to permit them to increase their price caps for accelerated depreciation --- would tilt the playing field so dramatically in the LECs' favor as to in effect pick them in advance as winners of the competition that Chairman Hundt wishes to foster.

I. THE SHARING MECHANISM IN THE PRICE CAP APPROACH TO LEC REGULATION PROVIDES AN ESSENTIAL CONSUMER PROTECTION AGAINST EXCESSIVE MONOPOLY TELEPHONE SERVICE RATES AND SHOULD BE RETAINED

Although the FCC has changed its regulatory methodology from traditional rate of return regulation to price cap regulation, it has retained the central goal of ensuring that consumers of LEC monopoly telephone services pay just and reasonable rates. Indeed, the NPRM makes clear that the Commission's intent in adopting price cap regulation was to reduce LEC monopoly rates below levels that would otherwise have been attainable:

[3/] Address to the National Press Club (May 2, 1994) at 7.

The price cap limits are set by the Commission to assure that rates are reasonable and *lower than under rate of return regulation.*[4]

A number of factors make it difficult for the FCC to be certain that the price cap formula actually achieves the goal of constraining monopoly rates to be lower than they would otherwise have been under rate of return regulation. Unforeseen changes in overall economic conditions, such as the precipitous decline in interest rates during the past three years, can cause the price cap formula to be excessively generous across the board. Simple misjudgment of the achievable productivity factor can skew the price cap formula in favor of the LECs. Regional differences in demand growth, population density, customer mix and the initial network configurations among the LECs can make even nationwide price cap ceilings that appear reasonable on an aggregate basis too easy for particular LECs to meet, which would generate windfall profits to LEC shareholders.

For all these reasons, the basic price cap formula alone is insufficient to guarantee that monopoly telephone service ratepayers are paying just and reasonable rates under price cap regulation. Therefore, the Commission wisely added an essential additional element to the price cap structure: the sharing mechanism. By requiring the LECs to share profits in excess of a target rate of return with monopoly ratepayers, the Commission reduces the likelihood that LEC rates exceed the levels that

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[4] NPRM at ¶12 (emphasis supplied).

would be determined to be just and reasonable under traditional rate of return regulation. Thus, the sharing mechanism provides an essential safety valve that protects against excessive monopoly rates and thereby helps to prevent the LECs from cross-subsidizing their competitive services with monopoly telephone service revenues.

CCTA urges the FCC to retain this essential protection for LEC monopoly telephone service ratepayers. No other aspect of price cap regulation so directly insures that these ratepayers will share in the efficiency gains that the LECs are expected to achieve under price caps. Any modifications to the sharing mechanism should be expressly designed to increase the likelihood that monopoly telephone ratepayers will receive their fair share of the productivity benefits of price cap regulation, not to eliminate these benefits altogether.

II. THE LECS SHOULD BE REQUIRED TO COMPENSATE MONOPOLY SERVICE RATEPAYERS FOR THE FOREGONE BENEFITS OF REDUCED INTEREST RATES THROUGH A ONE-TIME REDUCTION IN LEC MONOPOLY RATES

As the Commission notes in the NPRM, the LECs enjoyed the significant dual benefits of higher profits and lower capital costs during the first three years under price caps.[5/] CCTA has no objection to allowing the LECS to retain the benefits of higher profits, so long as those increased profits are the result of LEC efficiency gains. LEC shareholders, however, benefitted disproportionately over the past three years from the reduction

[5/] Id. at ¶ 44.

in capital costs associated with the sharp decline in interest rates over that period.

Under traditional rate of return regulation, monopoly ratepayers would have been entitled to significant rate reductions to pass through the effects of such massive capital cost reductions. Under price cap regulation, LEC shareholders appropriated all these benefits to themselves.

To restore the appropriate balance between ratepayer and shareholder interests, the Commission should adopt a one-time reduction in LEC monopoly rates to compensate monopoly ratepayers for the foregone benefits of reduced interest rates. Although interest rates have risen somewhat in the past few months, LEC shareholders will continue to benefit for many years to come from the low-cost, long-term debt newly issued or refinanced during the interest rate trough. In addition, even with the modest increase in interest rates, long-term interest rates still compare favorably with those in effect when the price cap plan was first implemented, and thus the cost of equity remains close to, or even somewhat below, the level prevailing when the FCC initially adopted the LEC price cap plan.

In CCTA's view, the reductions in long-term interest rates over this three-year period alone are sufficient to justify a rate reduction equivalent to at least a 100 basis point reduction in the LEC's rate of return. A rate reduction by the LECs to reflect lower interest rates is long overdue. The unfortunate unintended consequence of withholding this reduction is a price cap plan which is too generous to shareholders. The Commission should act immediately to ensure that monopoly ratepayers receive the rate reductions to which they are entitled.

Consideration of interest rate changes does not remove any of the efficiency incentives of the FCC's price cap plan. These changes are wholly outside of the control of the LECs and result in purely serendipitous profits. The FCC can be confident that if interest rates had instead risen to double-digit levels over the past three years, the LECs would be clamoring for relief to the Commission. Thus, the FCC's suggestion that changes in interest rates be taken into account on an ongoing basis in some automatic manner merits active and positive consideration.[6]

III. THE COMMISSION MUST HOLD THE LINE ON PREVENTING THE LECS FROM PASSING THROUGH THE EFFECTS OF DEPRECIATION RATE CHANGES TO MONOPOLY RATEPAYERS

With the opportunity to enter more and more competitive service markets, the LECs are rapidly moving to invest in network upgrades that would be unnecessary -- or, at the least, premature -- for the provision of monopoly telephone services. CCTA fully expects that the LECs will seek to accelerate the rate at which they depreciate their existing local exchange networks as a method of funding new investment in broadband networks. Although accelerated depreciation may be an appropriate accounting device to reflect internally what is actually occurring in LEC networks, it must not become a regulatory vehicle blessed by the FCC for

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[6] NPRM at ¶45.

the LECs to obtain cross-subsidies from monopoly telephone ratepayers for their competitive ventures.

In its initial LEC price cap order, the Commission correctly ruled that depreciation rate changes are not included in the category of "exogenous costs" for which the LECs may request "Z-factor" adjustments to the price cap index.[7] Such exogenous cost treatment is given only to changes beyond the carrier's control, and then only to a limited number of such costs.

Nothing has happened over the past three years to call into question the wisdom of this policy judgment. Instead, the announcement of major planned investments such as Pacific Bell's proposed hybrid fiber-coax network to provide both competitive video dial-tone services and monopoly telephone services, emphasizes the importance of ensuring that the LECs cannot shift the costs of competitive entry onto monopoly telephone ratepayers through higher depreciation charges.

The FCC should reaffirm its policy of excluding depreciation rate changes from the list of allowed exogenous costs or Z-factor adjustments to the price cap index. It should, if anything, narrow the list of allowable adjustments still further to provide monopoly ratepayers with even greater protection against excessive LEC rates.

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[7] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd. 6786, 6807 (1990).

IV. CONCLUSION

Retention of the essential sharing mechanism, a one-time rate reduction to reflect lower capital costs, and retention of the ban against making exogenous cost or "Z-factor" adjustments to price caps for depreciation rate changes all help to ensure that monopoly ratepayers will not be overcharged for telephone services and that competitors will not have to compete against subsidized LEC rates. CCTA, therefore, requests that the Commission adopt CCTA's policy recommendations as part of its revised LEC price cap plan.

Respectfully submitted,

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